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ECONOMIC REPORT

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RECORD GDP GROWTH IN Q3, BUT STILL WELL BELOW PRE-RECESSION PEAK; PATH FORWARD LESS CERTAIN

SUMMARY

- Real GDP growth set a record in the third quarter, increasing 33.1 percent at an annualized rate.
- Consumer spending led the rebound, with housing also strong. Trade and government were drags on growth.
- After the initial very strong rebound from the Viral Recession, economic growth will be much slower in the near term.
- Personal income and consumer spending both rose in September from August. Personal income is down from April, however, due to fading fiscal stimulus.
- In PNC's baseline forecast real GDP returns to its pre-pandemic level at the end of 2021.
- Highly expansionary monetary policy remains a big positive for growth, but the continued spread of the pandemic and a lack of fiscal stimulus are downside risks to the outlook.

Real GDP increased 33.1 percent at an annualized rate in the third quarter, by far the strongest growth on record. This does not mean the economy grew by one-third in the third quarter; instead, this means that if the economy maintained this pace of growth for an entire year the economy would be 33.1 percent larger at the end of that year. On a simple percentage basis growth was 7.4 percent in the third quarter. Real GDP is the broadest measure of economic activity; it is output of final goods and services, adjusted for inflation.

This record gain in the third quarter followed a record drop in real GDP of 31.4 percent annualized in the second quarter (9.0 percent unannualized), which was on top of a 5.0 percent annualized decline in the first quarter (1.3 percent unannualized). All told, output of goods and services shrank by 10.1 percent unannualized between the fourth quarter of 2019 and the second quarter of 2020. Even with the record increase, in the third quarter of 2020 real GDP was still 3.5 percent smaller than it was in the fourth quarter of 2019 (see Chart 1). To put this in context, a 3.5 percent decline in real GDP would still be the third-worst recession in the post-World War II period. During the Great Recession of 2007 to 2009, real GDP declined a total of 4.0 percent over six quarters.

Consumer spending, supported by stimulus efforts, led the third quarter rebound. It rose 40.7 percent at an annualized rate, adding more than 25 percentage points to annualized growth. Growth was especially strong for spending on durable goods, such as cars and appliances, up more than 80 percent annualized. Fixed business investment was also strong, up 20 percent annualized, adding almost 3 percentage points to growth. All of the improvement in business fixed investment came from equipment; investment in structures and in intellectual property (like software and research and development) both fell in the third quarter. Residential fixed investment jumped 59 percent annualized in the third quarter, adding more than 2 percentage points to growth, as homebuilding rebounded. Investment in inventories added almost 7 points to annualized growth in the third quarter.

Trade was a huge drag in the third quarter. Exports increased 60 percent annualized in the third quarter as global trade flows began to normalize, but imports jumped a whopping 91 percent as consumers purchased more imported goods as spending rebounded. With imports up far more than exports, trade subtracted more than 3 percentage points from annualized third quarter growth. Government was also a drag in the third quarter, subtracting a little less than 1 percentage point from annualized growth. Federal spending was down around 6 percent annualized, with state and local spending down about 3 percent.

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Nominal (before inflation) personal income rose 0.9 percent in September, after falling 2.5 percent in August. Labor market income rose 0.8 percent over the month as the economy continues to add jobs during the recovery from the Viral Recession, and there was also an increase in personal income from business profits. There was a very small decline in income from transfer payments from the government as the number of people receiving unemployment benefits continues to decline. After-tax income also rose 0.9 percent in September. With modest inflation in September, real (inflation-adjusted) after-tax income rose 0.7 percent in September from August.

After-tax personal income jumped by almost 13 percent in April from February, even as employment fell by more than 22 million over those two months, as the government sent out one-time stimulus checks to most households, made more people eligible for unemployment insurance, and boosted unemployment benefits by an extra $600 per week. Personal income has fallen since then, notwithstanding the September increase, as there have been no more stimulus checks and bonus unemployment insurance payments have expired, although rising labor market income as employment has rebounded has somewhat offset the reduction in transfer payments. After-tax personal income in September was 4.5 percent above its February level, before the pandemic, but was down 7.5 percent from April, when most households received their stimulus payments (see Chart 2).

Consumer spending increased 1.4 percent in September from August, before inflation, the fifth straight monthly gain. Spending on durable goods rose 3.0 percent over the month, while spending on nondurable goods increased 1.5 percent and spending on services rose 1.1 percent. Inflation-adjusted consumer spending was up 1.2 percent over the month.

Consumer spending fell by more than 18 percent from February to April as many businesses closed in the early stages of the pandemic and shoppers stayed home. Consumer spending was up more than 20 percent in September from April, but was still 2 percent below its February, pre-pandemic, level. Consumer spending on durable goods in September was above its pre-pandemic level and spending on nondurable goods was almost back to its February level, but spending on services was still more than 6 percent below where it was in February.

Chart 1: Record Third Quarter Growth, But Economy Still 3.5% Smaller Than Its Late 2019 Peak

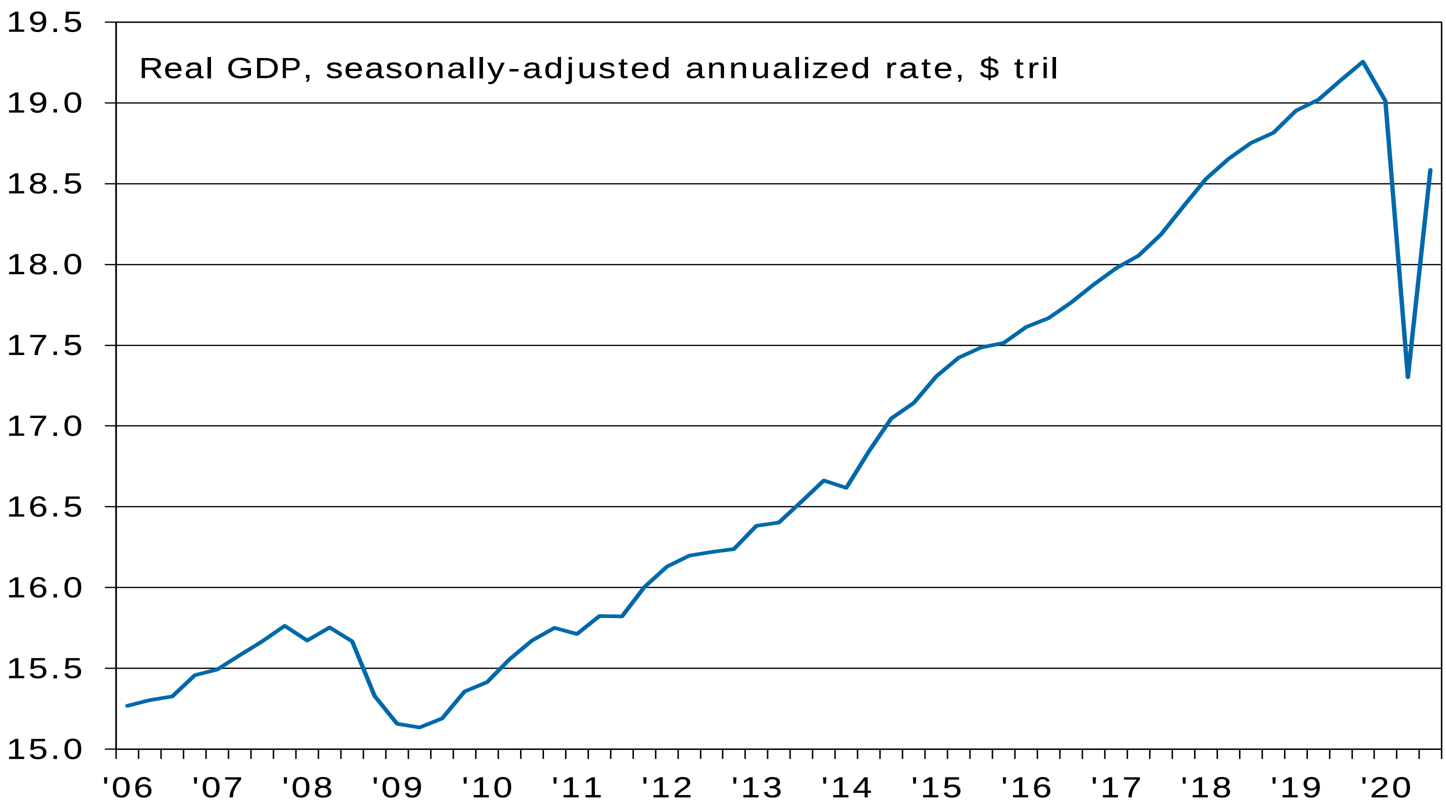

Chart source: Bureau of Economic Analysis

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With consumer spending up more than after-tax income in September, the saving rate fell to 14.3 percent, from 14.8 percent in August. The saving rate is still far above February's 8.3 percent rate; it soared to 33.6 percent in April, the highest saving rate on record, as income jumped thanks to transfer payments and households were unable to make many purchases because of restrictions on economic activity. The high saving rate gives households a financial cushion as the unemployment rate in September was 7.9 percent, well above the 3.5 percent rate in early 2020.

Monetary policy remains the one big positive for near-term growth. With the Federal Reserve pushing both short-term and long-term interest rates to record lows, the huge rebound in the housing market is due in large part to record-low mortgage rates; rock-bottom interest rates have also supported strong auto sales. But the central bank can only do so much, and Fed officials have pleaded for more fiscal stimulus. A huge package of federal aid—including support for consumers, small and mid-sized businesses, and state and local governments—would go a long way in ensuring a strong recovery. But any package will not come until the upcoming lame duck session of Congress, and perhaps not even until 2021, if at all.

PNC's baseline economic forecast assumes that Congress eventually passes a stimulus package of around $1.5 trillion. Even so, economic growth will be much, much slower in the fourth quarter of 2020 and through 2021, although it will still be well above its long-term trend. PNC's baseline forecast has real GDP returning to its pre-pandemic level at the end of 2021. Risks are weighted to the downside, including no containment of the pandemic and inadequate fiscal stimulus.

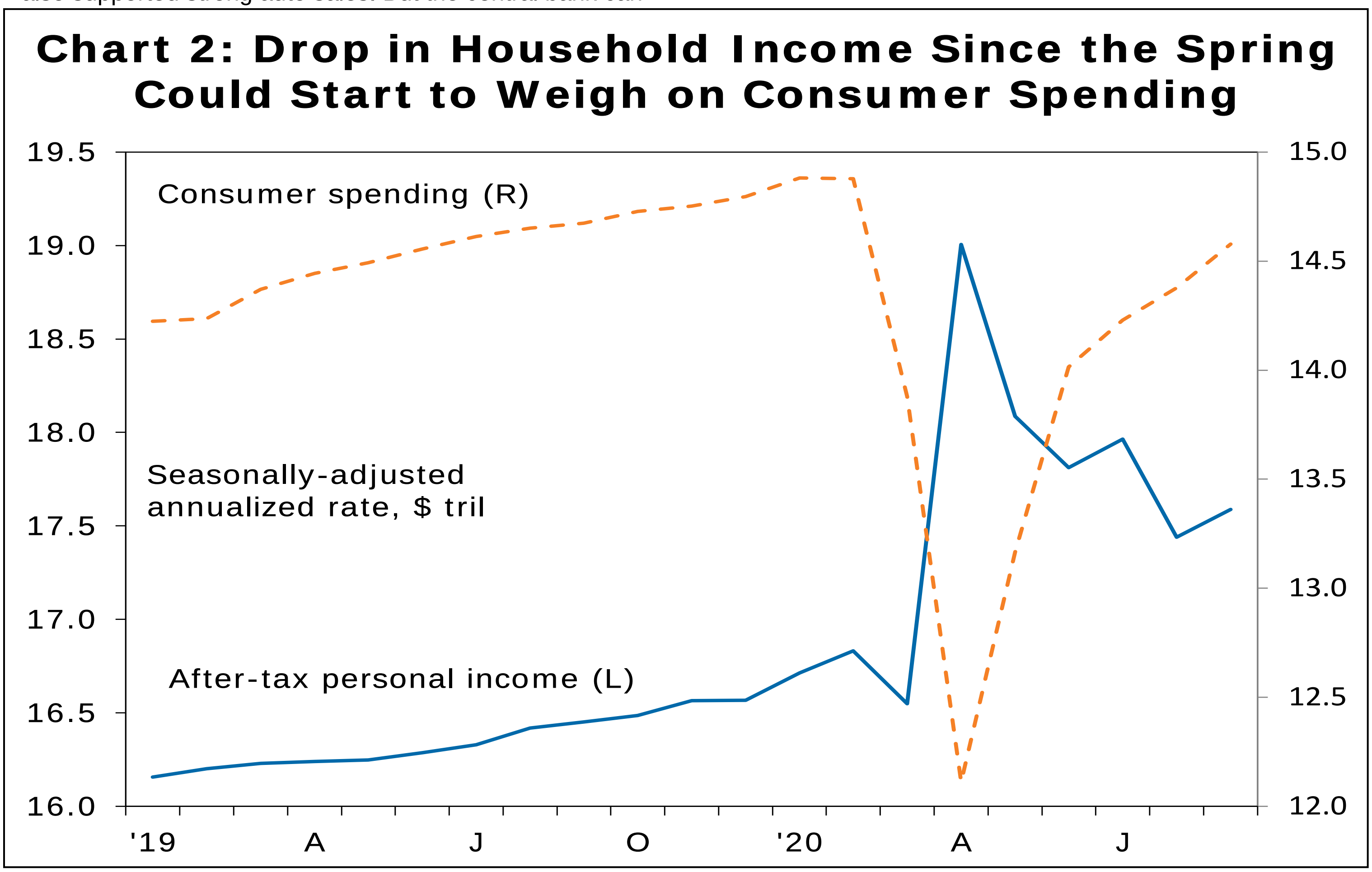

Chart source: Bureau of Economic Analysis

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